

PRESIDENT AND CEO'S MESSAGE TO SHAREHOLDERS

It is terrific to be with Nortel, and I really look forward to working with Harry and the Nortel Board of Directors. Nortel was a great company for many years, and we intend to make it great again. We find ourselves at the beginning of that task. Though positive change is underway across the company there is much work to do.

In my book, financial strength is the foundation for all company aspirations. The bottom line is that our financials are not strong. Restoring financial strength is priority #1. In fact, Nortel has not been 'free' cash-flow positive or shown consistent, profitable growth since 1998. For 2005, Nortel reported revenues of \$10.5 billion, net loss of \$2.6 billion, (including \$2.5 billion for litigation expenses) and operating cash outflow of \$0.2 billion. Our debt rating isn't good and our stock did not perform well in 2005 (as in most years since 2000). My commitment to you is that this will change. And it must.

The financial objectives that we have set are:

- Double-digit operating margins
- Strong cash generation and credit rating
- Consistent revenue growth greater than the market and, of course,
- Improved share price

Nortel has a proud history. The company has consistently invented and led the world in networking technologies. We intend to continue that technology leadership, and start a new tradition of delivering consistent value to shareholders. It won't happen overnight, but the journey is underway.

As I write this, I have been leading Nortel for five months. Since November, I have met with hundreds of customers, partners and suppliers around the world. They want us to win, and are telling us how. I have toured our world-leading innovation labs, and met with thousands of our employees. They are deeply talented, proud and a very competitive group. Our people want to rebuild this company and are prepared for the tough journey ahead.

In my travels to get to know our key stakeholders, I've lost my voice several times, drank hundreds of bottles of water, and caught colds on four continents. I have seen our challenges up close, and the more I see, the more I like our chances. I can't think of a place I'd rather be right now than leading Nortel.

The rest of this letter provides our perspectives on:

- industry outlook
- organizational assessment of Nortel
- leadership values we are instilling
- our short and longer-term goals

An Industry in Transition

Before discussing our short and long-term priorities, let me share with you our thoughts on where the industry is heading and some of the key trends to watch. It's an exciting time to be part of this industry, and I am bullish on the opportunities. The days of irrational exuberance for tech spending are behind us, and that is good.



Mike S. Zafirovski
President and CEO

Consumer and business demands are pulling through new networking technologies and services at a very rapid rate.

We have reached an inflection point on broadband service adoption and with it we are entering a new dimension in communications, computing and entertainment. Broadband wireless technologies like CDMA 1xEV-DO and HSDPA are rapidly increasing access to multimedia services similar to DSL and FTTx services.

We continue to see convergence of the various stand-alone networks around the world into new, integrated networks that deliver powerful broadband capabilities. In addition, there is an increasing focus on services and software to not only support basic communications, but also to support business operations, information management, government security and enhanced consumer entertainment.

Consumers want personalized, multimedia services so that they can control access to their information and maintain their privacy. Enterprise customers are moving toward convergence of real-time communications with IT. And finally, we continue to see increased demand and penetration for mobility services – particularly new services in voice, video, rich multimedia and security in both mature and developing markets around the world.

Business Made Simple

So what does all of this have to do with Nortel? In a word, it means opportunity. Nortel has always been focused on creating customer value and has the experience to deliver carrier-grade services across wireline, wireless, enterprise and multimedia broadband networks. We have one of the broadest portfolios in the industry.

One key ingredient in recreating Nortel is our new customer-oriented mission of "Business Made Simple." It is our mantra for driving cultural change internally and it will come to life through

our behavior and actions. The premise is simple: We are simplifying our own business, making it easier for customers to do business with us and making our products simpler and more intuitive. In turn, we are going to simplify our customers' networks and improve the overall communications experience for businesses and consumers. Our unyielding commitment to deliver unmatched customer value will position Nortel to become "most preferred" among the communications industry leaders.

We have a passionate focus on customers and we are working with major customers to simplify their networks and deliver powerful business and life-improving experiences. With more than 300 wireless networks installed in over 50 countries, Nortel's major service provider customers include Verizon Wireless, Cingular, Sprint Nextel, Orange, T-Mobile and Vodafone. Nortel has completed more than 750 carrier VoIP installations in the United States alone since 2003. Nine out of 10 Fortune 500 companies, the US Department of Defense across 50 states, and seven of the world's largest stock exchanges rely on Nortel's enterprise solutions each day. We are also a leader in SIP deployments and maintain a leadership position with our optical presence.

Our innovations are transforming the way people live and work. Here are just some examples:

- The M-Taiwan (Mobile Taiwan) project is designed to ensure high-speed, wireless broadband access is available almost everywhere on the island for real-time communication services. Taipei, the largest city in Taiwan, is well on its way to meeting mobility targets through Wireless Mesh Network technology from Nortel.
- Nortel and Verizon Enterprise Solutions have deployed healthcare solutions for Montefiore Medical Center and Cambridge Health Alliance, two of the largest and most widely recognized healthcare systems in the United States.
- Nortel deployed a high-speed HSDPA network for Partner Communications. Partner will be the first to launch HSDPA services in Israel and is among the first operators to launch HSDPA services anywhere in the world. The deployment allows Partner to add more 3G users while enabling DSL-like speeds for data.
- In Alberta, Canada, Nortel WiMAX technology is meeting the challenge of providing affordable wireless broadband access for residents in rural, remote areas who previously had no high-speed connectivity.

Organizational Assessment of Nortel

I've rolled up my sleeves and gotten down to work. I have done, and continue to do, a great deal of analysis on the business and am still getting to know the people who make Nortel tick. There is a passion and commitment in our employees that I have trouble finding the words to describe. Our employees' grit, determination and passionate customer focus have carried the beacon of light for this company through the darkest days of its otherwise proud 110-year history of excellence and innovation.

Of course, it's not about any single individual or only for the senior leadership team to carry the torch. You have the commitment and promise of all of our employees that we will continue to work tirelessly around the world to restore Nortel to its rightful place – a place of industry leadership and profitable growth.

As I said earlier, we have much work to do. Based on external inputs derived from surveys with employees, customers and suppliers, below is the inventory of our corporate "positives" and "must improve" areas:

Positives

- Strong innovation DNA
- Customer partnering
- Employee talent & resiliency
- Global footprint
- Scalability of products
- Strong brand

Must improve

- Over-complexity of the business
- Financial performance
- Decision-making processes
- Quality of products & solutions
- Accountability
- Focus

My strong take-aways and beliefs are that our positives are significant and difficult to replicate. At the same time, our challenges are also significant, but the management team believes, very fixable. We don't believe we're looking through rose-colored glasses. Rather, we have adopted an attitude of "forceful optimism." This is a mindset, belief and attitude that we expect from everyone at Nortel – a combination of positive anticipation for the future combined with a determined approach to maximizing its potential.

Leadership Values

Forceful optimism is one of the 30 attributes (see attachment) supporting our six leadership values outlined in the box at the top of the next page. Our senior team came together to identify the values by which we will lead and run our business going forward. And, after studying Nortel's past and current culture, we selected these six values to ingrain into our corporate culture. Our employees have told us that this represents a very different approach from the way the company has been run in the past. But, these values are becoming the basis for how we recognize and measure our people. Living and leading by these values will be a key ingredient in creating a high-performance culture at Nortel, and we're on our way to delivering just that!

NORTEL LEADERSHIP VALUES

- Chart a winning course.
- Are decisive
- Inspire others
- Meet commitments
- Live the core values
- Act as one

Passionate, Relentless Pursuit of Superior Results
and Doing the Right Thing

See full leadership attributes page vii

Short-Term Priorities

The initial focus of the leadership team has been to kick-start the path to profitability and operational excellence, ensure integrity is at the heart of all we do, and increase the focus of our R&D investments. We call this plan our BIG initiative, and it includes:

- **B**usiness Transformation
- **I**ntegrity Renewal
- **G**rowth Imperatives

Through Business Transformation, we are targeting to deliver in excess of \$1.5 billion in operating expansion in 2008. We will achieve this by addressing our biggest operational issues and opportunities. In total, 120 employees are working on these initiatives and are reporting good progress.

Our Integrity Renewal plan puts the focus on how we conduct business. It means a recommitment to the controls and checks and balances important to ensure we put ethics, integrity and corporate governance at the forefront of everything we do.

Our Growth Imperatives focus on market opportunities where the company can achieve a leadership position. We have a team currently conducting a full review of our R&D priorities and investment areas. Our goal is not to shrink R&D, but rather to drive strategic R&D investments to achieve our Growth Imperatives. For example, we have made decisions to significantly increase investment in promising areas, such as IMS, WiMAX, and IPTV, while stopping funding for our services edge router and selling certain assets of our Blade Server Switch Business unit. Many more decisions will be made in the coming months.

Longer-Term Objective: Recreate a Great Company

Make no mistake; our plan is to recreate a great company. This is a journey that will take us three to five years to complete. We call our roadmap to get us there our “6-point plan” to increase shareholder value. The plan confronts our shortcomings head-on and ensures we drive value in the Nortel brand and with all investors and stakeholders. The first three help build a strong foundation that “allows” and enables profitable growth, the desired outcome of the last three points.

- 1. World-class management team, culture and processes** - There is a new leadership team (18 in total) at Nortel. More than 80 percent of us have been in our jobs for less than a year. We are combining the best inside talent at Nortel with terrific external hires who are bringing new perspectives to the company.

We’ve also put a premium on leadership development at all levels of the organization. As part of our new operating rhythm, we spent a full two weeks in a “Session I” review where we looked at every organization and conducted extensive reviews of people, their development plans and our succession plans.

In the areas of development and training, Six Sigma quality teams are forming in a number of key areas across the company, and we’ve introduced a new program known as “Own It!” It’s designed to empower all employees with common problem-solving tools that will lead to a more efficient, responsive and competitive Nortel.

- 2. Aggressive focus on the balance sheet, corporate governance and business/finance controls** - We are committed to these disciplines, are investing significantly, and have put the supporting processes for maximum sustainable impact.
 - Ongoing remediation efforts including those that will lead to the removal of the five material weaknesses in our internal controls;
 - Implementing the Financial Transformation project and related systems;
 - Achieving the top quartile ranking for corporate governance; and,
 - Aggressive cash generation / debt reduction.
- 3. Drive to world-class cost structure and quality levels (and mid teens operating margin)** - Today, based on external benchmarks we are at a cost and quality disadvantage. Through various Business Transformation and Six Sigma quality programs, we are kick-starting our processes to significantly improve our quality, customer satisfaction and operating margin. On the last item, we have opportunities to drive substantially equal improvements in gross margin, G&A, and R&D levels.
- 4. Target a minimum of 20 percent market share for all activities** - This effort is to ensure market and thought leadership. Ideally, we would be at 20 percent across all of our business categories, but today this is not the case in more than half of them. Our challenge is to identify those areas where we can lead through increased investments and partnering. These are not easy decisions as we balance customer

relationships (highest priority) and revenue generation with ramp-up time for future opportunities. This is a longer-term approach and philosophy that will help us achieve leadership.

5. Invest for profitable growth - Growth to a vibrant business is the equivalent of water and oxygen to plants. You grow or you extinguish. We have and will continue to invest for growth, but with significantly higher rigor and expectations. Our R&D spend (\$1.9B) as a percentage of revenues is substantial but under-leveraged as a result of spotty New Product Introduction and development practices. Our investment levels (and capabilities) in go-to-market activities, effective partnering, and brand building have been below market-leading standards.

We are setting aggressive targets and roadmaps, including adoption of proven best practices, to create more customer value and higher internal returns for our growth investments.

6. Increase emphasis on service and software solutions - We have a stretch goal of doubling our revenue mix in this area. We recognize the fundamental shift taking place in the industry and are making investments in the growth areas of our Services business, including

Integration, Optimization, Security, Managed and Maintenance services and applications.

By taking the above steps, we are building the long-term foundation for the new Nortel. Of course, this won't happen overnight. But I'm pleased with the progress that we've made in the past five months in each of these six areas.

There is a growing sense of confidence in the company that we are making the right decisions for the right reasons and that performance will follow. This isn't about easy fixes or miracle quarters of performance. Rather, it's a journey we are very excited to embark on. It's a journey that we will pursue with passion, ingenuity, determination and persistence unrivaled by our competitors.



Mike Zafirovski
President and CEO, Nortel

Nortel Leadership Values with Attributes

Chart a Winning Course

- Create a simple, customer-oriented vision worth achieving
- Know their people, customers and markets
- Devise a strategy playing to Nortel's strengths
- Follow through with measurable objectives and plans
- Celebrate wins and reward performance

Are Decisive

- Make timely decisions and commit
- Have the courage to make tough decisions
- Are self-disciplined and focused on the end goal
- Face reality and act accordingly

Inspire Others

- Create an atmosphere that excites all stakeholders
- Bring energy and forceful optimism in executing priorities
- Foster a performance-driven culture
- Are self-confident
- Act as a visible catalyst in driving our vision

Meet Commitments

- Consistently deliver superior results
- Keep their word
- Visibly lead by example
- Simplify
- Communicate progress and encourage candid feedback

Live the Core Values

- Exude and command integrity
- Feel accountable for Nortel's success
- Create customer value
- Build strong, diverse teams and develop people
- Are innovative and are open to ideas from anywhere
- Expect urgency without forsaking quality

Act as One

- Exemplify "Nortel First"
 - One Vision, One Purpose, One Goal
- Harness the power of passionate teamwork
- Are ambassadors who represent one Nortel
- Intolerant of bureaucracy and complexity
- Embrace a global culture strengthened by collaboration and inclusion